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A Navy Escrow Account: Increasing Financial Flexibility

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A NAVY ESCROW ACCOUNT: INCREASING FINANCIAL FLEXIBILITY

Introduction

The current fiscally constrained environment creates several challenges for Department of the Navy (DoN) and Department of Defense (DoD) financial managers. One of the most critical is balancing operational requirements with the need to replace aging assets such as ships, aircraft, and facilities. To that end, transforming the current financial practices within the DoN/DoD is required.

This paper addresses the proposed Navy escrow account, a mechanism for eliminating wasteful spending while maximizing all available financial resources. The account, as envisioned, would provide financial managers with the incentive to generate cost savings and the means by which those funds could be recapitalized.

The creation of an escrow account coincides with the Navy's *Sea Enterprise* initiative, the resource enabler of *Sea Power 21*. *Sea Enterprise* builds upon the three strategic imperatives of changing the culture, changing structure and processes, and harvesting savings.[1]

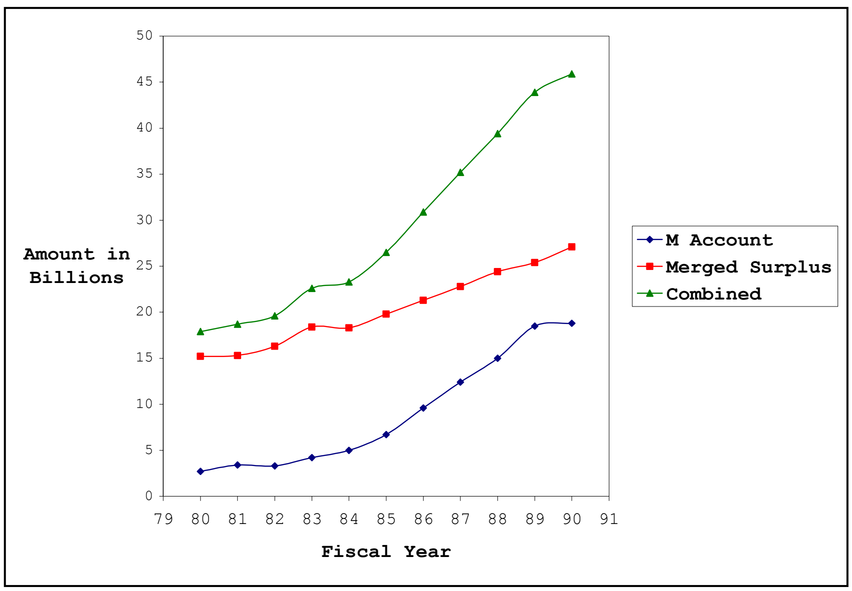
Previous Programs – The "M" And Merged Surplus Accounts

Retention of unobligated and/or surplus funds is not a new concept within the DoD. Starting in 1956, the DoD maintained the "M" Account – for obligated but unexpended budget authority and the Merged Surplus Account – for budget authority that had not been obligated.[2] They

provided a mechanism for retaining control of appropriated funds, whether unobligated or unexpended balances, within the agencies creating the obligations and effectively eliminated the need for additional congressional action to cover upward adjustments.

The rapid growth of the M Account mirrored the expansion of the DoD budget in the 1980's (Figure 1). The balance within the two accounts would reach $45.9 billion by 1990 and, surprisingly, went largely unnoticed by Congress.

Figure 1 M and Merged Surplus Account Growth



However, following the Air Force's admission that it planned to use roughly $1 billion from the M Account for B1-B avionics upgrades in 1989, the accounts began to draw considerable congressional interest.[3] Perceiving that the DoD, through the M and Merged Surplus Accounts was circumventing congressional intent, Congress began the process of enacting new legislation. With the signing of

P.L. 101-510, the M and Merged Surplus accounts were eliminated as of September 30, 1993.

Current Tools - Transfer Authority and Reprogramming

With the elimination of the Merged Surplus account, the ability to redistribute funds within the DoD was significantly reduced. Although current legislation and DoD regulations provide for the transfer of funds between appropriations and the reprogramming of funds within appropriations, there are two significant limitations: 1) the amounts available for transfer and reprogramming are limited and 2) the procedure can be lengthy.

The congressionally established transfer limit in the FY2002 Defense Appropriations Act of $2 billion, although not insignificant, represents roughly half of one percent of the total DoD appropriation. In terms of reprogramming authority, thresholds are established in the DoD Financial Management Regulations, beyond which, congressional approval is required to reprogram funds. As an example, a cumulative increase of $15 million or more in Operations and Maintenance (O&M) funds within a budget activity requires congressional approval.[4]

However, the procedures for gaining such approval have proven to be lengthy. In his FY2004 Defense Budget Testimony for the House Armed Services Committee (HASC), Secretary of Defense Donald H. Rumsfeld commented:

> ”The Department of Defense spends an average of $42 million an hour – yet we are not allowed to move $15 million from one account to another without getting permission from 4-6 different congressional Committees, a process that can take several months to complete.”[5]

The Navy Escrow Account

The proposed Navy escrow account provides a buffer for rapidly shifting requirements and budgetary shortfalls in a more efficient and effective manner than current transfer authority and reprogramming capabilities. It creates an incentive for generating cost savings and the means to redistribute those savings toward emergent financial demands or unfunded requirements. It is a tool for transforming the business operations within the DoN: away from a "zero balance" baseline and towards prudent financial stewardship.

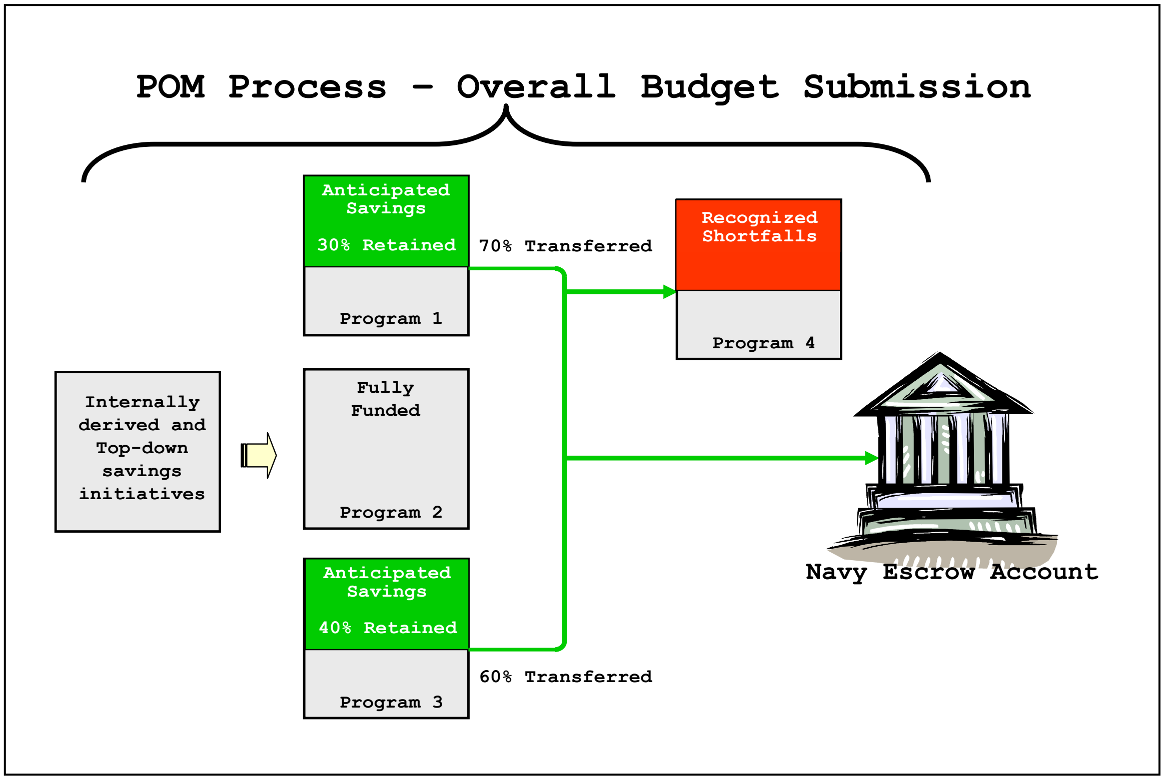
Conceptually, the Navy escrow account would function in a similar manner to the traditional escrow accounts. Funds will be transferred to the account from anticipated savings or savings in the execution phase, and held for future payment of legitimate obligations.

Navy Escrow Account Input Process

The funding inputs to the Navy escrow account will originate at three distinct periods within the budget cycle: during the build of the Program Objective Memorandum (POM), during the execution phase, or at the end of the fiscal year. The quality of the savings, in terms of the probability of fully realizing their value, varies at each phase. During the POM build, the savings are theorized; based on efficiency measures or programs that are projected to generate savings. As such, there is a possibility that some savings will not materialize as predicted, possibly affecting operational capability.

Alternatively, the savings realized during the execution phase and approaching the end of the fiscal year (August to September timeframe) will present fewer opportunities to influence operations.

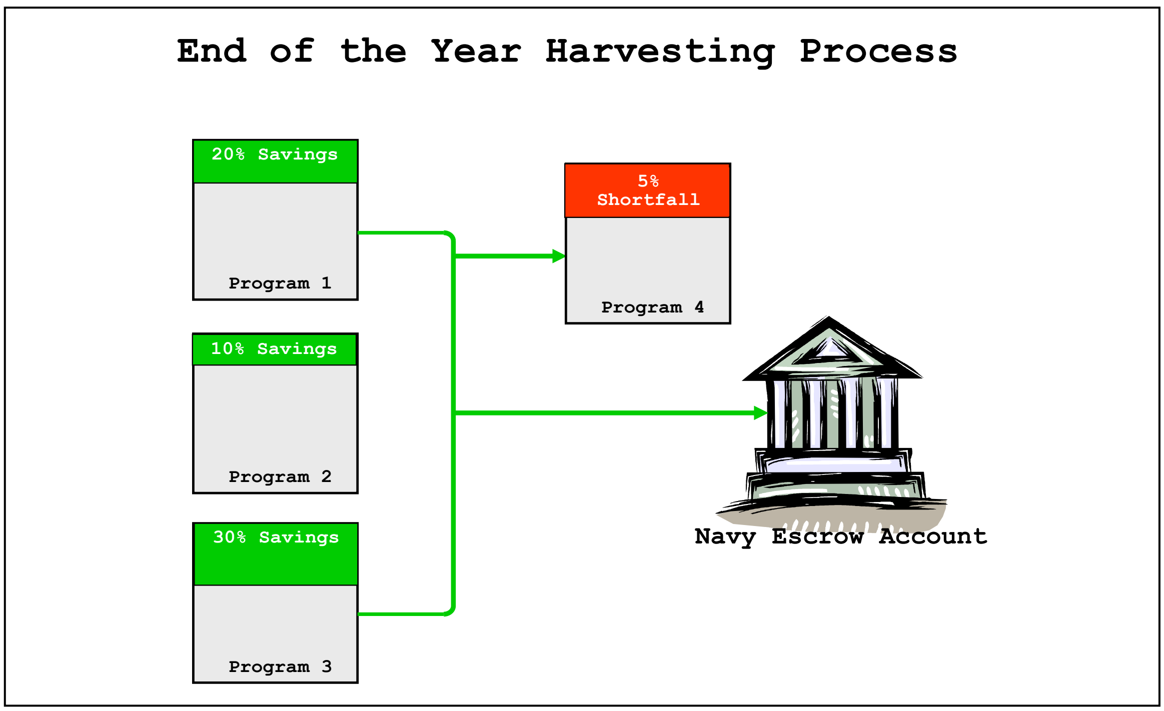
Figure 2 POM Harvesting Process



To help mitigate some of the risk associated with the early identification/transfer of funds in the POM process, a percentage system, based on the confidence of the projected savings, could be established. This would not only provide funds for programs facing shortfalls, but also a goal for the command projecting the savings to reach and a safety net if circumstances prohibit the savings from being realized. Figure 2 outlines the potential POM transfer process.

The process for harvesting savings during execution will originate from top-down and bottom-up initiatives. As in the current process, the Mid-Year Review will play a critical role in designating potential savings. However, for the process to be successful there must be a shift in the mental models that guide the review processes. In lieu of rushing to obligate, commands must adopt a more inclusive corporate view of budget execution: spending funds when warranted, reducing outflows when able.

Figure 3 End of the Year Harvesting Process



With each day approaching the end of the fiscal year, the level of risk from harvesting funds decreases. As such, the proposed process for harvesting end of the year funds is simplified when compared with the other harvesting periods: funds not obligated at the end of the fiscal year

are available for transfer into the Navy escrow account. However, if shortfalls exist within the DoN, harvested funds will first be transferred into the required appropriations, with the balance forwarded to the escrow account. Figure 3 highlights the flow of funds.

With each source of funds, there are advantages and disadvantages. Table 1 outlines the critical factors associated with POM, execution, and end of the year funds.

Table 1 Input Advantages and Disadvantages

Origin	Advantages	Disadvantages
POM	1. Provides an incentive/goal for execution. 2. Potential source of funds for programs facing known shortfalls. 3. Provides more time to make strategically smart financial decisions	1. External and internal competition for funds may eliminate savings. 2. Mission readiness suffers due to reductions. 3. Top-down reductions may not gain support at lower levels.
Execution	1. Provides an incentive for execution. 2. Institutionalizes a cultural shift away from the 100% obligation mindset. 3. Increase fiscal flexibility.	1. Reluctance to relinquish budget authority. 2. Fear of the unknown or emergent requirement. 3. Difficult to create the required "shared vision" for successful implementation.
Fiscal Year End	1. Savings easily identified. 2. Helps eliminate end of the year rush to obligate 100% of budget authority. 3. Increases scrutiny of 4th quarter spending.	1. Fear of negatively affecting future budgets – "spend it or lose it" mentality. 2. Desire to spend for upcoming year's requirements. 3. Cancellation of valid local projects to meet "corporate" objectives.

Navy Escrow Account Uses

Utilization of Navy escrow account funds fall into three distinct categories: funds to cover unexpected shortfalls, funds to resource previously unfunded requirements, and funds to be applied to future obligations. From the standpoint of gaining widespread acceptance, specifically from Congress, covering shortfalls with internally derived resources is a critical aspect of fund utilization. Although the concept of covering existing shortfalls as the first priority seems logical, this has not always been the practice. During the 1980's, as the Merged Surplus account continued to grow, DoD received over $11.25 billion in six supplemental appropriations.[6]

The second claimant on escrow funds will be unfunded requirements. These requirements may be in the form of a congressionally pre-approved and prioritized list created annually or simply as an emergent requirement (e.g., additional Joint Direct Attack Munitions).

The third manner in which Navy escrow account funds may be utilized is in their application towards future years' obligations. These may be programs or procurements planned in the future that can be readily supported by the requisite contractors and existing infrastructure.

Balance Adjudication

The preferred process for the Navy escrow account is to have all transferred funds lose their fiscal year identity and original purpose, essentially becoming "no

year – no color" funds. This provides the greatest flexibility and allows for prudent financial decisions to be made without time or purpose restrictions.

Other possibilities include the development of a share ratio between the DoN and the general Treasury, where a given percentage of funds remains within the DoN and while the remaining balance is transferred to the general Treasury. This obviously minimizes the incentives to Navy financial managers, but may provide a necessary level of congressional oversight to make the account politically acceptable.

A third possibility is the creation of obligation periods and/or balance limits. Under this scenario, funds transferred into the Navy escrow account may be available for obligation for a designated time-period or up to a certain amount. Funds would be transferred with a specific date tag that would result in a given obligation period for the funds. The obligation periods may be similar to existing limitations such as one year for O&M or three years for Aircraft Procurement, Navy (APN) from the time they are transferred into the escrow account. The balance limits may be based on a specific dollar amount or percentage of total obligational authority (TOA) for a given fiscal year.

Levels of Control

There would be two levels of control for the Navy escrow account: those internal to the DoN and those external. Within the DoN, to achieve the maximum benefit,

the Navy escrow account should operate under corporate control. As noted by the Chief of Naval Operations (CNO), Admiral Vern Clark:

> "What would make a local commander think he has a better use of [generated] savings, than corporate headquarters?"[7]

The proposed process would have the respective Program Sponsors submitting proposals based on fleet inputs to the Resource Sponsors, who would then present a unified plan to the Deputy Chief of Naval Operations (Resources, Requirements and Assessments - N8) for submission to the Office of the CNO. This process has the potential, as seen in reprogramming battles, to be lengthy. However, mitigation of escrow decisions and creation of an unfunded requirements list could be made in a fashion similar to current budget decisions.

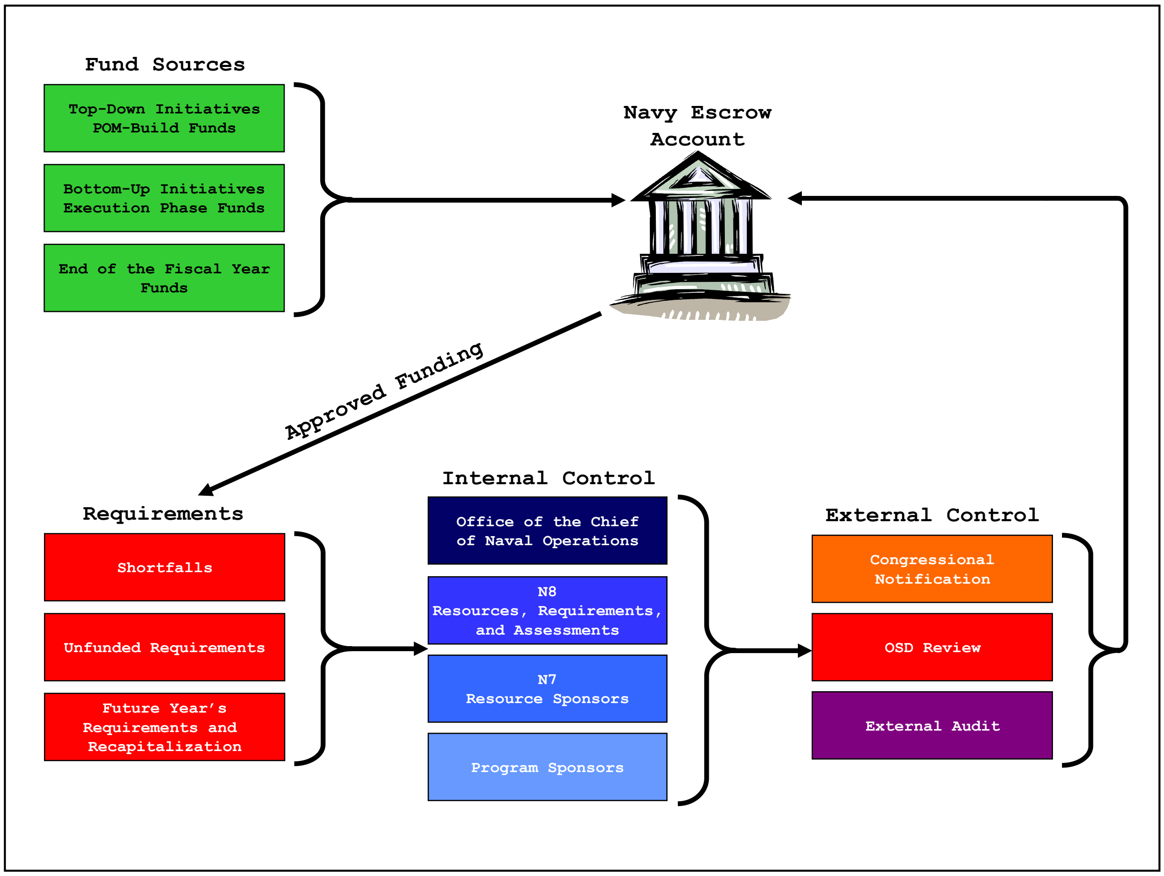
As such, the CNO, Commandant of the Marine Corps, FMB, Assistant Secretary of the Navy (Financial Management and Comptroller)(ASN(FM&C), and the Secretary of the Navy would play active roles in the final review of the unfunded requirements list. Reducing the decision making time and internal battles for increased budget authority is clearly one of the most difficult, internal challenges to successful implementation.

External controls would focus on gaining DoD approval, through the Office of the Secretary of Defense (OSD), and congressional approval, through a House and Senate Appropriations Committees (HAC and SAC), as well as the House and Senate Armed Services Committees (HASC and SASC).

A notification process, with a specified time allotted for review, could be established to expedite the process.

The final level of review is the presence of an external audit and standardized reporting procedures. Figure 4 graphically summarizes the proposed operation of the Navy escrow account.

Figure 4 Navy Escrow Account Operations Diagram



Potential Model Programs

Although there is no one existing program in operation, on any scale, that contains all of the functionality desired in the Navy escrow account, several

programs have established the precedence for the recapitalization or future application of actualized savings.

In preparation for the FY2001 and FY2002 budgets and as part of the “Smart Work” concept, Budget Submitting Offices (BSOs) were encouraged to review manning requirements for the various commands under their auspices.[8]

The program enabled Commanders to eliminate non-essential billets or those that did not optimize mission accomplishment. The critical mechanism and incentive within the program was an ability to reapply any savings achieved to unfunded approved program requirements. Proposals for reapplying savings were evaluated in the budget review process and subsequently approved if they were consistent with manpower management goals and departmental and service priorities.[9]

The reapplication of savings was similarly established in the Military Housing Privatization Initiative (MHPI) and the Family Housing Improvement Fund (FHIF).[10] MHPI enables the DoD to work with the private sector to build and renovate military housing. Funds deposited into the FHIF originate primarily from direct appropriations and the transfer of appropriated Family Housing construction funds.

The account is limited to a total budget authority of $850 million and all transfers must be for a defined project and at the full, appropriated value of the project. However, within the FHIF, considerable flexibility exists. Unobligated funds from one project can be transferred into the FHIF. They can then be obligated for a project from the Family Housing Master Plan in the same or different

location. For projects requiring the transfer of funds into the FHIF, a 30-day congressional notification period is required.[11]

Within the FHIF, the funds retain their original purpose – family housing. However, other DoD programs, such as those designed to improve the conservation of energy and water at DoD facilities, provide the ability to utilize savings in other areas. Two programs are noteworthy:

- Title 10 U.S.C. § 2865 – Energy savings
- Title 42 U.S.C. § 8287 – Energy Savings Performance Contracts (ESPC)[12]

Included in these measures are provisions for retaining portions of the savings beyond the current fiscal year and obligating those savings towards unrelated, but defined, projects and/or programs.

Title 10 U.S.C. § 2865 allows the retention of two-thirds of the appropriated funds resulting from the energy cost savings initiatives remaining at the end of the fiscal year.[13] An annual recurring provision contained in the DoD appropriations acts allows the remaining balance to be available for obligation into the following fiscal year.

The savings not obligated in the current fiscal year are subsequently transferred into an extended availability account. They are available for expenditure for five years following the year in which the funds expired for obligation at the end of the year of extended availability – a total of six years.

One-third of the savings must be used at the installation where the savings were realized, at the discretion of the Commanding Officer. Notably, the funds can be used for improvements to existing family housing, unspecified minor construction improving the quality of life for personnel, and any morale, welfare, or recreation (MWR) facility or service.

Title 42 U.S.C. § 8287 is an amendment to Section 736 of the National Defense Authorization Act for FY1989. Section 736 addresses ESPCs, which enable Federal agencies to improve the energy efficiency of their facilities without depending on congressional appropriations for capital improvements. As compensation for the capital investments, the private firms are awarded a share of the savings during the term of the contract (not to exceed 25 years).[14]

The total cost savings realized during the first five years of the ESPC are available for obligation. Of the funds generated through an ESPC program, one-half may be used for any MWR facility or service or for any minor military construction project enhancing the quality of life of military members at the installation at which the savings were realized.

Statutory Barriers

Although the proposed escrow account increases financial flexibility, there are significant statutory barriers prohibiting its creation. Within the various codes that govern the financial practices of the United

States Armed Forces, there are two distinct categories: codes that define the appropriation process and codes that define the obligation/expenditure process.

Appropriations Process

The overarching restriction applicable to the appropriations process and the foundation for many of the other relevant codes is found in the United States Constitution, Article I, section 9, clause 7. The text is as follows:

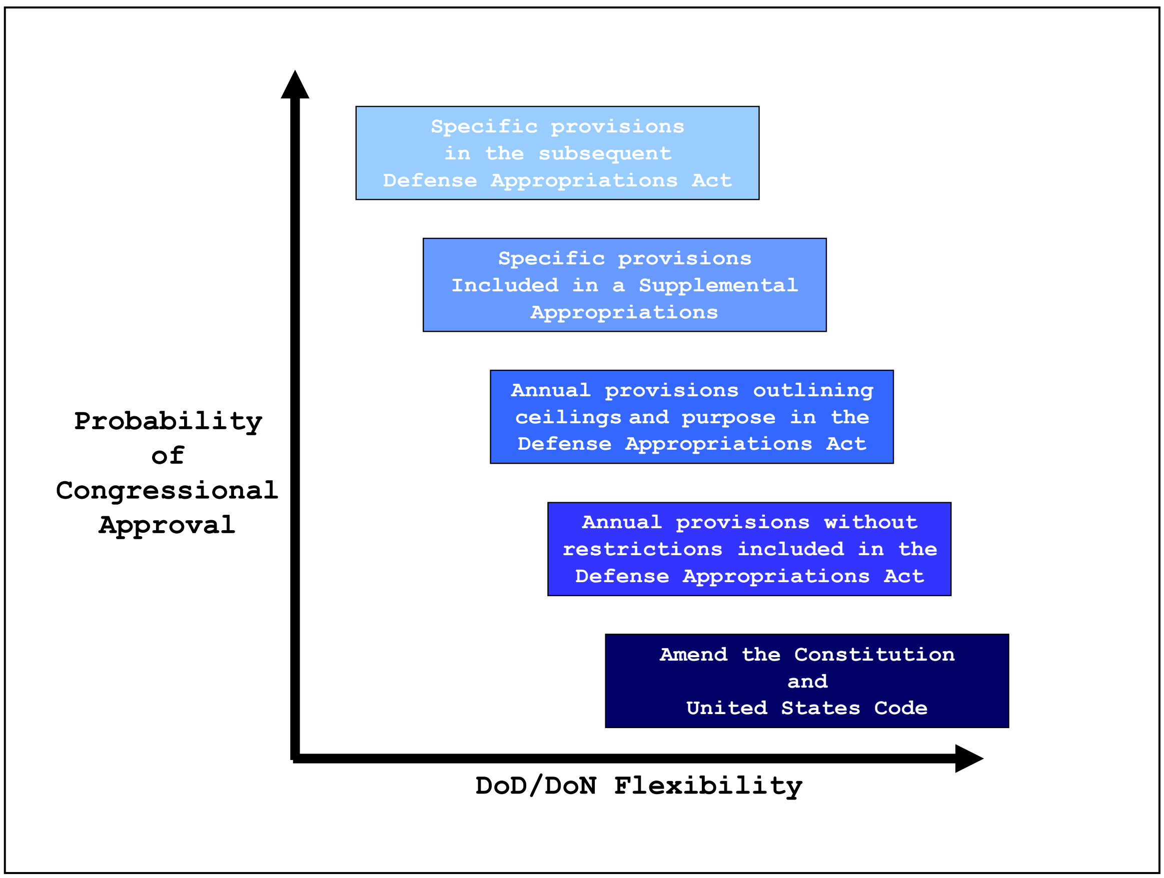
> "No money shall be drawn from the treasury, but in consequence of appropriations made by law."[15]

Additionally, the requirement for "authorization in law" exists throughout Title 10 United States Code (U.S.C.). Defining the specific requirements for the armed forces, Title 10 contains numerous applicable sections that prohibit the flexibility desired in the Navy escrow account:

- Title 10 U.S.C. § 114 – defines the potential sources for obligations within the Armed Forces (e.g., aircraft, weapons, operations and maintenance, etc.).
- Title 10 U.S.C. § 2802 - further defines the scope of actions characterized as military construction.
- Title 10 U.S.C. § 2821 – details additional requirements for construction and acquisition of military family housing.

The escrow account, as proposed, will operate outside of the standard appropriations process and in conflict with the aforementioned statutory requirements. There are several possibilities for creating a mechanism that complies with the letter and intent of the existing laws governing the appropriations process. For each corrective action, there is an associated probability of gaining congressional approval and a respective increase in overall DoD/DoN flexibility. Figure 5 highlights the continuum of possibilities.

Figure 5 Statutory Mitigation Possibilities



Obligation and Expenditure Processes

The statutory limitations governing the obligation and expenditure processes are contained in Title 31 U.S.C. The individual sections provide guidelines as to the purpose, time, and amounts available for obligation. Accordingly, they each present a different challenge in the implementation of the Navy escrow account.

Title 31 U.S.C. § 1301 establishes the requirement to maintain the application or purpose of appropriated funds.[16] Commonly referred to as the "color of money" statute, it prohibits the obligation of appropriated funds for any purpose other than that originally stated.

Similar in function to Title 31 U.S.C. § 1301 is Title 31 § 1532, which governs the withdrawal of funds from one appropriation and the subsequent crediting to another fund. The procedure, unless authorized by law, is prohibited.

Removing the purpose or "color of money" tag from appropriated funds and allowing their transfer between appropriations is essential for the operation of the proposed escrow account. In the design of the operational procedures, the enabling legislation could allow for the removal of the "color tag" at initial transfer or during the obligation period. Figures 6 and 7 graphically demonstrate these possibilities.

Additionally, there are three specific codes within Title 31 that add the element of time to appropriations. Title 31 U.S.C. § 1502, § 1552, and § 1553 define various aspects of the obligation period and the procedures required when the availability period expires. The obligation period, or the time in which valid obligations

can be made, varies and is dependent on the type of appropriation. As an example, O&M funds can be obligated for a period of one year, while military construction (MILCON) funds have a five-year obligation period.

Figure 6 Color Tag Removed During Initial Transfer

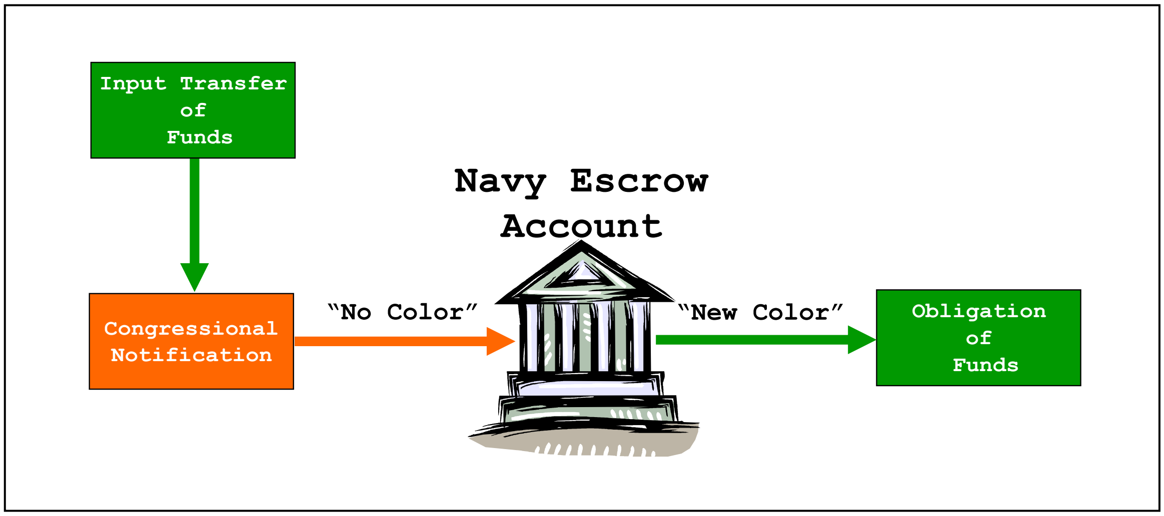
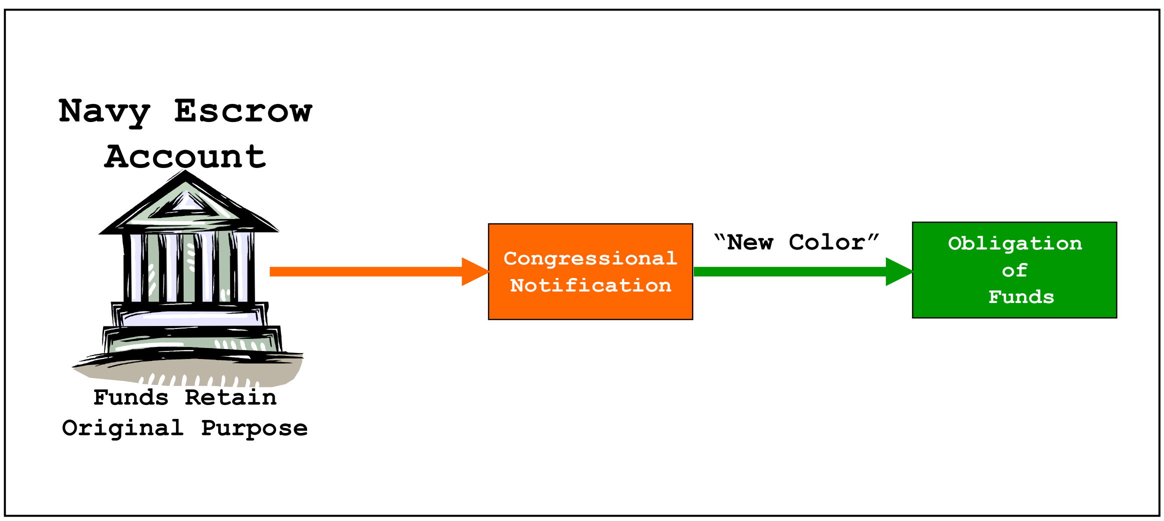


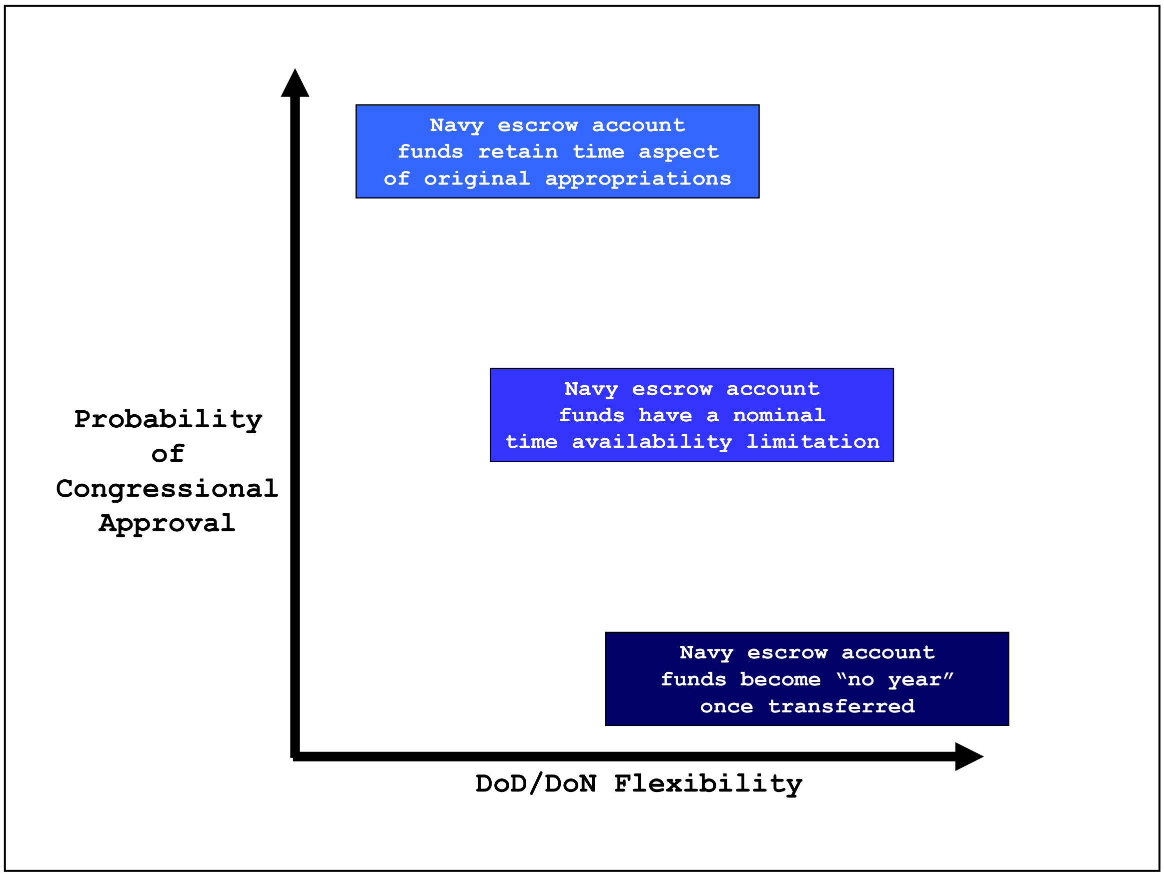
Figure 7 Color Tag Removed During Obligation



Within the continuum of possibilities for new legislation enacted, as part of the establishment of the

Navy escrow account, there are the two extremes: the funds retain their fiscal year identity or the funds lose their fiscal year identity. Figure 8 highlights the relationship between flexibility and probability of gaining approval for the various options.

Figure 8 Time Aspect of Transferred Funds



Cultural Barriers

The previous section presented the statutory barriers to the implementation of the Navy escrow account. Although they are significant, they represent only a portion of the implementation equation. The second aspect, and part of

the strategic imperatives associated with the *Sea Enterprise* initiative, is changing the existing culture.[17]

Cultural Barriers in the Department of the Navy

There are three prevailing cultural barriers within the DoN/DoD: 1) the "spend it or lose it" mentality, 2) the use of budget execution as an evaluation tool, and 3) the reluctance to adopt a corporate perspective. First, the "spend it or lose it" mentality throughout all government organizations is well documented. The common anecdotal belief is that any funds unobligated in the current year of execution will be instantly reduced from next year's budget. With the extreme competition for funds, it is not unreasonable for financial managers to assume that unobligated funds place their programs at risk for future funding.

Second, within the DoN's current evaluation system, there is not a standard metric for evaluating the financial management performance of the officers charged with budget execution.[18] The level of effort placed on evaluating this skill set, excluding comptrollers, budget officers, large program managers, etc., consists of nothing more than checking the balance in the account at the end of the fiscal year. If the account is empty (without being overspent), the officer with the responsibility for that account is deemed successful. Although this is an oversimplification, it is close to the truth for many operational commands.

Finally, there will be resistance to adopting a "corporate perspective" towards relinquishing budget authority. Some of the resistance will be simply an unwillingness to make local sacrifices for the greater good. However, collective efforts often result in a diffusion of responsibility, as no one individual is directly responsible for the success or failure of the program. Without a financial target or direct accountability, people may not feel the need to perform or contribute (deindividuation).[19]

Cultural Barriers in Congress

The cultural barriers with Congress center on two issues: the erosion of the congressional power base, including their ability to maintain the intent of the original appropriations, and their responsibilities to constituents, political party, and party leaders.

The proposed Navy escrow account is a return to the principles of Alexander Hamilton and the Federalists who argued for lump sump appropriations back in the earliest days of the United States.[20] It represents, to some extent, a shift away from current practices of line item specificity and a mechanism for bypassing congressional intent.

This attack on congressional intent will be difficult to stop at the DoN, as approval of a "DoN only" escrow account is unlikely. It must be assumed that any escrow account would be established for the DoD as a whole, and

possibly, by default, desired by each major agency within the federal government.

With $775 billion proposed in discretionary spending for FY2004, if only half of one percent is transferred into various escrow accounts, $3.875 billion would be out of the direct control of the full House and Senate (for the DoN, the same percentage represents over $573 million in transferred funds).[21] In addressing the issue of control and intent, it is important to view the proposed escrow account for what it is, as well as the precedent it establishes.

The second cultural barrier is the impact of local and/or partisan politics. Deals between Congressmen and Senators are part of the appropriations process. The potential for projects to be delayed or accelerated, funds to be transferred into different states and districts, may create potential battles during the notification process. They may be purely geographic in nature, along party lines, or in response to the concerns of constituents. The proposed Navy escrow account has the potential for circumventing the original agreements and intent contained in the Defense Appropriations Acts. Therefore, problems may arise during any attempt to obligate escrow funds.

Confronting these cultural problems, both within the DoN/DoD and Congress, will require tangible and institutionalized procedures, exceptional leadership and education, combined with a sustained and consistent focus over time. There are no automatic solutions in confronting cultural change of this magnitude. However, strategies for managing the cultural change process can increase the

probability of successfully implementing an escrow account mechanism.

Conclusions and Possibilities

The proposed Navy escrow account, as envisioned, would provide financial managers with the incentive to generate cost savings and the means by which those funds could be utilized for the greater good of the DoN. By providing the means by which unobligated funds may be retained, transferred, and subsequently obligated, the escrow account will help eliminate the often-wasteful practices that occur at the end of each fiscal year. Instead of rushing to obligate funds for fear of losing budget authority in future years, prudent financial stewards may recapitalize those funds to replace an aging fleet of ships, aircraft, and facilities. Additionally, by establishing targets during the POM build and allowing for transfer of funds throughout the year of execution, the account provides the DoN/DoD increased flexibility to actively manage budget execution and to gain the most benefit from the funds appropriated.

In researching the barriers to implementation, programs that are similar in function to the proposed escrow account, and potential account operations, five strategic imperatives stand out as being critical. Collectively, they provide the focus for successfully lobbying Congress, designing an implementation strategy, and controlling the funds within the escrow account

- Make Congress an ally – work with and not around congressional concerns.
- Focus must remain on operational excellence – the desire to generate savings cannot replace the need to maintain and improve current capabilities.
- To fully leverage generated savings, control of escrow account funds must reside at the corporate level.
- Communication and education on financial management issues and challenges throughout the DoN/DoD are essential.
- The change process must be actively managed.

The proposed account represents transformational change for the business processes within the DoN, DoD, and the federal government. It provides not only increased flexibility, but also increased accountability. In the current and projected fiscal environments, maximizing the resources provided to the DoN is essential for maintaining the current infrastructure and operational capability. With an increasingly aging fleet of ships and aircraft, reviewing existing financial mechanisms through a different lens may provide the only means of effectively recapitalizing current assets and obtaining the force structure envisioned by *Sea Power 21.*

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